DOCKET FILE COPY ORIGINAL

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington D. C. 20544

In the Matter of	)	
	)	
Federal-State Joint Board	)	**CC Docket No. 96-45**
On Universal Service	)	
	)	
Forward Looking Mechanisms for	)	**CC Docket No. 97-160**
High Cost Support for Non-Rural LECs	)	

REPLY COMMENTS OF THE TEXAS OFFICE OF PUBLIC UTILITY COUNSEL

In Response to Common Carrier Bureau Request for Comments on Proposals to Revise the Methodology for Determining Universal Service Support in Public Notice DA 98-715 (released April 15, 1998)

CONTENTS

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington D. C. 20544

In the Matter of	)	
	)	
Federal-State Joint Board	)	**CC Docket No. 96-45**
On Universal Service	)	
	)	
Forward Looking Mechanisms for	)	**CC Docket No. 97-160**
High Cost Support for Non-Rural LECs	)	

REPLY COMMENTS OF THE TEXAS OFFICE OF PUBLIC UTILITY COUNSEL

I. INTRODUCTION AND SUMMARY OF RECOMMENDATIONS

The Texas Office of Public Utility Council (OPC) appreciates the opportunity to reply to comments provided in the above captioned matter.[1] OPC is the state consumer advocate agency for Texas residential and small commercial ratepayers. It has actively participated in the universal service proceedings at the federal and state levels.[2]

In the notice, the Federal Communications Commission (FCC) proposed a specific set of questions for comment having to do with a few major issues in the implementation of universal service policy that have caused great concern nationwide. In particular, the FCC sought comment on proposals that would alter the FCC's initial 75/25 decision and allow high cost support to exceed the 25 percent offset. OPC vigorously supports such a change to the FCC's Universal Service Order. In re Federal-State Joint

---

1 Public Notice, DA 98-715 (released April 15, 1998). Initial comments were filed on May 15, 1998. References to initial comments are provided by company name.

2 At the federal level, OPC filed initial and reply comments at In the Matter of Federal-State Joint Board On Universal Service, CC Docket No. 96-45, April 12, 1996, and May 7, 1996, and has taken the lead in the court challenge to parts of the FCC's Order. Texas Office of Public Utility Counsel, et al., v. FCC, 5th Cir., Case No. 97-60421. At the state level, OPC has filed comments and participated in the state universal service workshops associated with Texas PUC Project No. 14929.

Board on Universal Service, Report and Order, FCC 97-157 (CC Docket No. 96-45) (released May 8, 1997), 62 Fed. Reg. 32862 (June 17, 1997) (hereafter Universal Service Order).

Unfortunately, several of the major local exchange carriers (LECs), including those serving Texas in particular (SBC, GTE and Sprint), have sought through initial comments to reopen many of the issues that the FCC correctly decided in its prior consideration of universal service policy. The FCC must thoroughly and decisively reject the misguided efforts of the local companies in their comments to create massive universal service funds and rebalance rates.

First, the 75/25 percent split is reviewed. OPC calls on the Commission to abandon that arbitrary limit for it fails to promote universal service as the Congress intended. OPC calls for a hold harmless floor to ensure that no state receives less support than prior to the passage of the Act. Moreover, if the Commission persists in its decision to limit federal support of universal service to 25% of the total, then the Commission must change its decision to use that 25% to offset only access charges. In order to promote universal service under a 75/25 percent scheme, the Commission must direct federal support to core services included in the definition of universal service.

Second, OPC reviews the fundamental methodology adopted by the FCC. The FCC should reaffirm its commitment to the sound economic principles that it outlined in the initial order, while correcting the few mistakes it made in crafting its universal service policy. In light of the comments, the FCC should restate the fundamental principles it adopted that recognize the economic nature of the telecommunications network.

- Prices and universal service support should be based on the forward looking economic costs of the network.

- The loop is clearly shared between a growing array of services and loop costs should, accordingly, be recovered from all services that use it.

- Reflecting the highly integrated nature of telecommunications network facilities, revenues from all services that use the network should be considered in determining the revenue benchmark for universal service support.

These are positions the FCC has adopted or supported in its initial order. It should reaffirm these policies and move vigorously to implement them for non-rural LECs.

Third, OPC calls on the Commission to apply its costing and pricing principles consistently across the trilogy of Telecommunications Act of 1996 proceedings. The FCC should amend its initial implementation of its universal service policy in a number of ways.

- In order to establish consistent universal service and competition policy, the calculation of support payments should be conducted on a basis that reflects the economic structure of the industry.

- The analysis should be conducted at a level of disaggregation that is consistent across all analyses. Universal service support areas should be the same as unbundled network element pricing areas.

Finally, the FCC should reject a variety of proposals raised in Comments that restrict the availability of universal service support and exceed the agency's authority.

- The FCC should reject calls to impose a federal obligation to serve on eligible telecommunications carriers. Altering the obligation to serve is premature, given the state of local competition, and is entirely a state matter.

- The FCC should reject efforts to restrict high cost support on the basis of income or other characteristics of inhabitants of a high cost area. The comparability of rates between high cost and other areas is solely a matter of prices charged and does not involve the separate question of affordability in this proceeding.

- The FCC has erroneously made a distinction between primary and secondary lines in its access charge docket. It should not, and legally cannot extend that distinction to the universal service docket.

A number of LECs have again tried to push the Commission toward the creation of a national welfare system for local exchange companies. Accordingly, OPC will restate many of the arguments it made against such proposals in its earlier comments to ensure that the Commission does not adopt policies and rules that will prove detrimental to residential and small business customers.

II. THE FCC SHOULD ABANDON THE 75/25 PERCENT APPROACH AND ADOPT A "HOLD HARMLESS" FLOOR DURING THE TRANSITION

The FCC's ill-considered effort to restrict federal support to only 25 percent of the universal service needs and to apply federal funds only to reduce access charges should be abandoned. OPC has amply documented the public policy and legal flaws in that decision.

A. THE FCC PORTION MUST SUPPORT DESIGNATED SERVICES OR ASSOCIATED FACILITIES, NOT INTERSTATE CARRIER ACCESS CHARGES

The FCC erroneously concluded that it did not have to provide support for the core services it had defined as the essence of universal service. Instead, it directed all federal support to the offset of access charges. In developing the argument that federal universal service funds would be applied only to costs in the federal jurisdiction, none of which entail universal service, it concluded that it did not have to support more than 25 percent of network costs. The result was to deny or reduce support to many areas that had previously received it.

The FCC tried to absolve itself of the need to support universal service by arguing that the states could pick up the difference. In so doing, the FCC yet again trespassed on state authority over intrastate ratemaking. In the months since the Universal Service Order was released, it has been suggested that the Commission has even contemplated going farther by conditioning the receipt of support on state actions to rebalance intrastate rates.

The FCC's reform of universal service was premised on two facts--neither of which have occurred. The FCC assumed that the emergence of competition would help drive prices to efficient levels. Existing universal service support embedded in interstate access charges would become unsustainable in such an environment. The FCC also assumed that the emergence of local competition would compel the states to reform existing intrastate universal service mechanisms by making such support more explicit. In this regard, the Commission trusted that state reform efforts would more than counteract any disturbances created in the wake of the FCC's efforts. As a result, the FCC modified the federal fund ahead of state efforts to reform intrastate universal service and even ahead of the emergence of local competition. The FCC, however, overestimated the pace at which local competition would grow.

In fact, the FCC has gotten it exactly backwards. Congress mandated that federal support be directed solely for universal service. It, therefore, required the FCC to define formally universal service support mechanisms. Congress did not in the Act in any way indicate a need for the states to define formally what there has not been any particular pressure in the past to define formally.

Contrast the language in the Act applied to the federal and state roles in the Act. First, the statute asserts the joint federal state responsibility for universal service.

> 254(b)(5) There should be specific, predictable, and sufficient Federal and State mechanisms to preserve and advance universal service.

The Act then specifies the responsibilities of each of the jurisdictions. The federal obligation to provide support is explicit and mandatory.

> 254(e) After the date on which Commission regulations implementing this section take effect, only an eligible telecommunications carrier designated under section 214(e) shall be eligible to receive specific Federal universal service support. A carrier that receives such support shall use that support only for the provision, maintenance, and upgrading of facilities and services for which the support is intended. Any such support should be explicit and sufficient to achieve the purposes of this section.

Note that the services <u>are</u> supported by the federal mechanisms and that support <u>shall</u> be used only for the intended services.

In contrast, the state role is discretionary.

> 254(f)A state may adopt regulations not inconsistent with the Commission's rules to preserve and advance universal service . . . . A state may adopt regulations to provide for additional definitions and standards to preserve and advance universal service within that State only to the extent that such regulations adopt additional specific, predictable, and sufficient mechanisms to support such definitioins or standards that do not rely on or burden Federal universal service support mechanisms.

States may refine the universal service definition. If they do, they must provide the appropriate support. Given this language, there is no way for the FCC to infer the authority to avoid its obligation or to shift it to the states, as the FCC has tried to do.

B. THE FCC SHOULD ENSURE SUPPORT IS NOT REDUCED AS A RESULT OF ITS NEW UNIVERSAL SERVICE SUPPORT METHODOLOGY

In implementing the Act, the FCC must find a way to move prices to efficient levels that will support competition, while discharging its obligation to support universal service. OPC believes that it should drop all reference to the 75/25 option, or any other upper limit on the percentage of universal service costs it is willing to bear. No such limits existed in Federal law before adoption of the Universal Service Order.

It must reject all proposals to impose these arbitrary limits on universal service support. The IXCs' proposals to simply stop payments on the completely arbitrary grounds that competition have not begun, or that some support may have been mistargeted in the past, make little public policy sense, are self-serving, and illegal.

While some argue for an arbitrary manipulation of the affordability benchmark as a means for controlling the size of the fund, OPC recommends that the FCC base the benchmark on a solid evidentiary basis. Any arbitrary manipulation of the benchmark to achieve a fund size will fail. As OPC's analysis has demonstrated, there is an economically reasonable, legal, and constitutionally valid basis for setting the benchmark. It must include a reasonable estimation of revenues from the full range of services that utilize the shared facilities of the telecommunications network. It can make these estimates over geographic areas that are economically and competitively valid (i.e. UNE zones).

In short, the Commission should conduct the analysis properly, as outlined above. OPC urges the Commission to make one, and only one deviation from that analytic principle, given the historical levels of support and the clear intent of Congress to maintain that historical commitment. It would be reasonable for the FCC to adopt a hold harmless provision, which ensures that no LEC has its federal universal service support

reduced during the transition to a new universal service fund support methodology. These economic principles and methodology should produce a universal service fund that identifies areas where the cost of efficient telephone service is truly high while it produces a fund that is manageable in size.

C. THE FCC SHOULD SUPPORT UNIVERSAL SERVICE IN THE FEDERAL JURISDICTION BY "OFFSETTING" THE SUBSCRIBER LINE CHARGE

Even if the FCC believes it can hold to the 75/25 split, it must change the manner in which federal support is applied. In order to support universal service, it should use federal universal service funds to reduce the subscriber line charge. The subscriber line charge is the sole federal charge levied on endusers for access to the interstate network. It represents one of the core services included in the definition of universal service. Therefore, federal universal service funds used to reduce the subscriber line charge (SLC) would meet this requirement of the Act.

III. FUNDAMENTAL PRINCIPLES OF NETWORK ECONOMICS AND UNIVERSAL SERVICE SUPPORT

The LECs insist that the Telecommunications Act of 1996 (hereafter the Act) requires the Commission to ensure that each and every line is profitable. Not only must every line cover its costs, which the companies define as every penny of historic embedded costs, but they also insist that it must do so on the basis of the revenue garnered from basic monthly service only. This view of the Act, if true, would compel

the Commission to either create a huge universal service fund or to require states to radically raise basic service charges.[3]

The LEC view of the 1996 Act is wrong. It is wrong on the economics and wrong on the law. The Commission must adopt a cost/recovery allocation methodology that recognizes the fundamental economics of the modern telecommunications network. This approach involves a number of areas of analysis -- (1) the analysis of the telecommunications network as a multi-product undertaking exhibiting strong economies

---

3 The most explicit statement of this view is provided by GTE. In the comments it asserts:

> The Federal plan must provide new, explicit support that is sufficient to replace the implicit support generated currently within interstate access charges . . . . A reasonable amount of new support to the states to replace support that is provided implicitly today by intrastate rates for services such as access, toll and vertical services (p. 5).

Earlier comments by GTE (April 27, 1998) make it clear that GTE intends to recover all loop costs from basic service and the entire difference between embedded and forward looking costs from basic service rates or a huge universal service fund. Southwestern Bell makes similar arguments (pp. 3-5). Sprint also makes similar arguments (pp. 2 and 6) for the federal and state levels, although it recognizes that the FCC does not have the authority to deal with state rate issues.

Bell Atlantic takes a different view. The Company argues that neither economic analysis nor the law justifies an excessively large universal service fund. It contends:

> Some of the plans vastly overstate the existing implicit support to high cost-universal service. The current amount of interstate high-cost universal service support is $1.7 billion. There is no validity to the claims of GTE and Sprint that the current fund is far higher.
>
> GTE, for example, uses all of the switched access revenues of all non-rural incumbent local operating companies (except for subscriber line charges), less the incremental costs of the same number of access minutes. This calculation vastly overstates the support. Interstate access rates have been reduced through price cap regulation, but their historical underpinning was the recovery of actual costs of the local exchange carriers, measured in conformance with the Commission's cost accounting rules, including shared costs assigned through separations for interstate recovery. These are legitimate costs that the exchange carriers incur to provide service and certainly cannot be considered a subsidy of any kind.
>
> Nor is there any validity to GTE's argument that the Commission must – or even should – replace all interstate and intrastate subsidies of every kind with a massive federal program. The only relevant requirement in the statute is that any *interstate universal service* support be "explicit and sufficient." GTE points to no section that requires all implicit subsidies currently in interstate rates must be made explicit and recovered through the fund, because none exists. Nor does the Act require, or even permit, the Commission to ferret out all *intrastate* subsidies and include them in the federal fund (p. 13).

Bell South seems to echo Bell Atlantic's sentiment. Indeed, the Joint Board's Recommended Decision, In the Matter of Federal State Joint Board on Universal Service, CC Docket No. 96-45, November 8, 1996, para. 223 suggests that these two companies have long held this view.

of scale and scope; (2) the treatment of loop as a common cost; and (3) reasonable understanding of competitive market behavior.

A. REPLY TO COMMENTS URGING ALLOCATION OF LOOP TO BASIC SERVICES

Telecommunications markets are inherently multi-product in nature. Competitors do not, and cannot, enter markets that enjoy substantial economies of scale and scope on the basis of the profitability of only a small subset of the products and services that can be produced. They cannot succeed with such an entry strategy because others who price their output in recognition of the multiple products they are selling would pick them apart. The economic evidence that the telecommunications network is a multi-product enterprise enjoying economies of scale and scope is overwhelming.

- On the supply-side, all long distance calls use the network exactly the same way local calls do. Vertical services (like Call Waiting, Call Forwarding and Caller ID) are supported by all parts of the network. Basic service accounts for only about one-quarter of total revenues generated per line.

- On the demand-side, customers expect to receive long distance service when they order telephone service. Vertical services are strong complements of basic service. If a provider sells basic service to a customer, competitors are very unlikely to sell that customer Call Waiting or other vertical services.

- Companies are desperate to sell local service and long distance bundled together. One-stop shopping is the current marketing model. In such a bundle, it no longer makes economic sense to think of local use as the cost causer, but not long distance, as the LECs claim.

Those who have argued in Comments for allocation of the loop to basic service for universal service purposes assert that the consumer intends to buy local service only when he or she decides to purchase service. Such notions lack subtlety. According to this view, if the customer wanted local service, local service must be the cost causer for

all costs of loop (even though it is a shared facility). The actual intention in the decision cannot be known, however, since customers may just as well believe they are purchasing access to all services (i.e. local, long distance, and vertical services) when they buy telephone service. Assigning costs on the basis of a guess about the intention of customers when they make a purchase raises subjectivism to an economic dogma.

A reasonable basis to determine the allocation of shared costs is to analyze the facilities and functionalities necessary and actually used in the production of goods and services. Although historical analysis tends to show that assumptions that attribute loop costs to basic local service only are a baseless metaphysical assertion, it nevertheless is impossible to unravel the network into true cost causation categories using economic analysis alone. Therefore, the only footing on which sensible economic analysis can be launched is an assessment of the product, not the psychology of the customer. One must analyze the facilities and functionalities necessary and actually used in the production of goods and services. The Commission should rely on a "service pays" principle. That is, services that use facilities should bear some cost responsibility for those facilities. There should be no free rides and assumptions about prime movers are arbitrary. Every service that uses facilities is a cost causer.

- As a matter of economics, costs for joint and common facilities should be recovered on the basis of the nature and quality of use that each service makes of those facilities.

- As a matter of public policy from a universal service docket perspective, recovery of joint and common costs should be structured in such a way as to promote universal service by keeping basic service affordable.

Now that the companies are falling all over themselves to sell bundles of services, the fiction that local service causes the loop should be put to rest once and for all. Since

the first decade of this century, the network, including the loop, has been consciously designed to serve local and long distance. Long distance was not an afterthought; it was always a forethought, included in the design, development and deployment of the network, as are vertical services today.

B. REPLY TO COMMENTS SUPPORTING INTRASTATE RATE REBALANCING

The companies have tried to bootstrap the requirement in the Act that support for universal service be specific, predictable, sufficient and explicit into a broad requirement for rate rebalancing, but this effort misinterprets the Act. Nowhere does the statute say anything about rate rebalancing. Not one member of Congress stood up on the floor and said that basic service rates would increase by 50 to 100 percent, as the industry has tried to impose in a number of federal and state proceedings, in order to promote competition. The point of §254 was not so much the addition of some new universal service principle (i.e., support must be explicit across the board) as the exclusion of certain principles from use as the basis for FCC universal service policy (i.e., support being used to offset the cost of providing non-universal services or facilities).

The recovery of joint and common costs across all services that share the underlying facilities certainly does not violate the Act. Claims that revenues from vertical service are not predictable are contradicted by decades of rate making. Most of the vertical service revenues come from services that are at least strong complements of basic service. They have been included in rate making even though they have a higher elasticity of demand than basic service. The certainty that companies seek in their revenue stream is far beyond current regulatory practice and beyond anything contemplated by the Act. Efforts to remove these revenue streams from rates and collect

them from a universal service stream, or to shift them to basic service, are bold efforts to protect the monopoly revenues of the incumbents.

The Commission should include revenues associated with all services that share joint or common facilities in the estimation of universal service funds requirements. This accomplishes the ultimate protection against misuse of universal service funds. By including all costs and revenues for services that share significant joint and common costs in the universal service analysis, there could no abuse of universal service funds. The cost of improperly allocated plant might still be recovered incorrectly from ratepayers in rates they pay for individual services, but no universal service funds would be used to subsidize those rates. The Commission must also include incremental cost of the suspect services.

To the extent that the Commission proposes to recover legitimate joint and common cost from these services, those joint and common costs will not disappear with the advent of competition. They will not disappear because the competitors must incur such costs if they seek to provide facilities of their own. Rather, competitive markets allow the recovery of efficient joint and common costs. Of course, if the competitors are more efficient they will recover a lower level of joint and common costs. The incumbents may have to become more efficient too (that is, lower their prices). This is not the "fault" of universal service policy. The margin goes down, not because the incumbent was saddled with universal service obligations but because it was bloated with inefficiencies or excess profits.

The failure to take legitimate joint and common costs into account would frustrate the purposes of the 1996 Act. Allowing incumbents to recover joint and common costs

excessively from basic service would not promote efficiency and it would frustrate competition, allowing incumbents to price more competitive services at an artificially low level. Allowing incumbents to recover an unreasonable share of joint and common costs from basic service (either directly in the price for basic service through rate rebalancing or indirectly by creating a large universal service fund, which is tied to the provision of basic service) insulates incumbents unfairly from market forces.

The cross-subsidy and joint cost language of 47 U.S.C. 254(k) addresses this point. It recognizes two distinct steps that are necessary to have fair and efficient pricing in the emerging, partially competitive, multi product environment -- a strict prohibition on below cost pricing and a reasonable recovery of joint and common costs across services that share facilities.

> 254(k) The Commission, with respect to interstate services, and the States, with respect to intrastate services, shall establish any necessary cost allocation rules, accounting safeguards, and guidelines to ensure that services included in the definition of universal service bear no more than a reasonable share of the joint and common costs of facilities used to provide those services.

The Conference Report states this principle even more vigorously. The Conference Committee Report clarifies the standard for cost allocation by adopting the Senate report language --

> The Commission and the states are required to establish any necessary cost allocation rules, accounting safeguards, and other guidelines to ensure that universal service bears no more than a reasonable share (and may bear less than a reasonable share) of the joint and common facilities used to provide both competitive and noncompetitive services. [4]

---

4 Conference Report, p. 129 (emphasis added).

In pursuit of universal basic service, this language establishes a reasonable share of joint and common costs allocated to basic service as an upper limit.

The foresight of policy makers in adopting these principles cannot be underestimated. They recognized the difficult economic and equity problems presented in reforming a century-old monopoly. Congress knew that monopolists, faced with the growing threat of competition, are inclined to shift costs onto their most captive customers. Monopoly providers will subsidize their competitive services, if they can, and they will certainly maximize the recovery of joint and common costs from those customers with the fewest options. This approach protects their revenue stream and gives the monopolists the greatest leverage against potential competitors. Such an approach is in the Company's interest, but not necessarily in the best interest of the public in general.

Even without an explicit subsidy, incumbents who have continuing market power over significant product or geographic markets gain an unfair advantage by allocating joint and common costs away from the most competitive market segments. The result is anti-competitive and unfair: (1) New entrants and competitors who do not have the luxury of recovering costs from captives are placed at a disadvantage; and (2) captive customers are forced to bear an unfair share of joint and common costs, while incumbents gain an unfair competitive advantage.

C. REPLY TO COMMENT REURGING "TAKING" ARGUMENTS

The local exchange companies claim that if they are left to recover costs from uncertain sources, such as Call Waiting, or intraLATA long distance, their property is being taken because in a competitive market they might not be able to sell as much as

they need to cover their costs.5 The law does not contemplate such insulation from competitive forces; it seeks to create them. Because the law starts from just and reasonable rates and recognizes the multi product nature of the firm, the opposite is the case. There is nothing in the constitution that requires rate rebalancing or a huge universal service fund.

Just and reasonable means utilities are allowed only an opportunity -- not a guarantee -- to recover costs that are used and useful.

- Prudence is not a guarantee of recovery in the marketplace or under regulation.
- Rates that are just and reasonable are required to provide service that is economically efficient.
- Individual cost elements are not the stuff of constitutional taking cases for utilities.
- Companies have no right to recover imprudent costs, excess profits or double compensation of risk.
- Companies can be required to reallocate costs to the services for which they were incurred, particularly where there is unreasonable, excess capacity or unnecessary, excessive functionality.
- The new revenue opportunities opened by the Telecom Act to the LECs must be included in any discussion of adequate compensation, especially where those opportunities are related to basic service on either the supply-side (by sharing facilities or costs) or the demand-side (by being sold in packages).

Utilities frequently cite the *Duquesne Light and Power Company v. Barasch* case to support their claims. One thing the utilities omit in summarizing the case is the fact

---

5 To the extent that the LECs have interjected stranded or legacy costs in the proceeding for the umpteenth time, this argument should be rejected (see Sprint, Exhibit A).

that they lost.6 The Court did not order the return of the millions of dollars of costs the utility alleged had been illegally taken. *Duquesne* teaches us the exact opposite of what the LECs claim and the lessons are directly relevant to a universal service proceeding.

- That case involved a regulatory switch. That is, the state of Pennsylvania had switched from a prudence standard to a used and useful standard, trapping costs that were denied recovery.
- The case turned on the observation that the consideration of a specific cost item was inappropriate when the overall return of the utility should be considered.
- The disallowance of costs also did not cause the utility severe financial distress and so it stood.

The Commission should take great heart from *Duquesne* in the context of the current proceeding. Here we have the utilities trying to cost out the piece parts of the network, refusing to count other revenues, and ignoring a wide range of new revenue opportunities, with bottom lines that are among the fattest in the nation. A universal service fund based on forward looking economic costs that includes costs allocated to services and revenues derived from all services that share facilities will easily pass constitutional muster when the LECs sue (as we well know they inevitably will). They will lose now, just as they lost then.

IV. USE OF THE FORWARD LOOKING COST METHODOLOGY INCORPORATING SHARED COSTS AND OTHER REVENUES IS CORRECT

A. CURRENT PRACTICE IS APPROPRIATE

The FCC, the states and the courts have found consistently and repeatedly that the loop is a common cost. The courts recognized this almost three quarters of a century

---

6 488 U.S. 299 (1989).

ago in *Smith v. Illinois*.[7] Many of the states have formally recognized this in comments in federal proceeding,[8] and in their own cost dockets.[9]

---

7 282 U.S. 133 (1930).

8 Two of the Regional Bell Operating Companies take this point of view (Bell Atlantic and NYNEX). A number of state regulators also take this view. Consider, for example, the following:

- "Comments filed by the Maine Public Utility Commission, the Montana Public Service Commission, the Nebraska Public Service Commission, New Hampshire Public Utilities Commission, New Mexico State Corporation Commission, Utah Public Service Commission, Vermont Department of Public Service, and the Public Service Commission of West Virginia," In the Matter of Federal-State Joint Board on Universal Service, FCC 96-93, CC Docket No. 96-45, April 12, 1996, (hereafter Maine et al.) p. 18.
- "Comments of the Idaho Public Service Commission," In the Matter of Federal-State Joint Board on Universal Service, FCC 96-93, CC Docket No. 96-45, April 12, 1996, (hereafter Idaho) p. 17;
- "Comments of the Public Utility Commission of Texas," In the Matter of Federal-State Joint Board on Universal Service, FCC 96-93, CC Docket No. 96-45, April 12, 1996, (hereafter Texas) p. ii;
- "Initial Comments of the Pennsylvania Public Utility Commission to the Notice of Proposed Rulemaking and Order Establishing Joint Board," In the Matter of Federal-State Joint Board on Universal Service, FCC 96-93, CC Docket No. 96-45, April 12, 1996, (hereafter Pennsylvania) p. 7;
- "Comments of the Public Utility Commission of Florida," In the Matter of Federal-State Joint Board on Universal Service, FCC 96-93, CC Docket No. 96-45, April 12, 1996, (hereafter Florida) p. 22;
- "Initial Comments of the Virginia Corporation Commission," In the Matter of Federal-State Joint Board on Universal Service, FCC 96-93, CC Docket No. 96-45, April 12, 1996, (hereafter Virginia) p. 5; and
- "Comments of the Staff of the Indiana Utility Regulatory Commission," In the Matter of Federal-State Joint Board on Universal Service, FCC 96-93, CC Docket No. 96-45, April 12, 1996, (hereafter Indiana) p. 9.

Virtually all Consumer Advocate Comments also share this view in their initial comments.

9 Consider, for example, the following:

- Report of Glenn P. Richardson, Senior Hearing Examiner, Application of GTE South Incorporated For Revisions to Its Local Exchange, Access and IntraLATA Long Distance Rates, Virginia Corporation Commission, Case No. PUC 95-0019, March 14, 1997, p. 84;
- Application of the Mountain States Telephone and Telegraph Company dba U.S. West Communications, Inc., for Approval of a Five-Year Plan for Rate and Service Regulation and for a Shared Earnings Program, Colorado Public Utilities Commission, Docket Nos. 90a-665T, 96A-281T, 96S-257T, Decision No. C97-88, January 5, 1997, pp. 42-43;
- Decision and Order Rejecting Tariff Revisions, Washington Utilities and Transportation Commission v. US West Communications Inc., Docket No. UT-95-0200, April 11, 1996, pp. 83-84,
- Department of Utility Controls Investigation into Southern New England Telephone Company's Cost of Providing Service, Department of Public Utility Control, Docket No. 94-10-01, June 15, 1995, pp. 24-25;
- Report and Order, In Re: US West Communications, Inc., Utah Public Service Commission, Docket No. 95-049-05, November 6, 1995, p. 95;

More importantly, in a series of recent rulings to implement the 1996 Telecom Act, the FCC has constructed a comprehensive paradigm that starts from the fundamentally correct premise that the loop is a shared cost. There should be no doubt that this is the correct treatment of loop costs and alternatives should be clearly and loudly rejected.

The FCC began in the local competition docket by recognizing that the loop is a common cost of local, long distance and the other services that use the loop.

> As discussed in greater detail below, separate telecommunications services are typically provided over shared network facilities, the cost of which may be joint or common with respect to some services. The costs of local loops and their associated line cards in local switches, for example, are common with respect to interstate access service and local exchange service, because once these facilities are installed to provide one service they are able to provide the other at no additional cost.[10]

The FCC followed that decision with its proposed rulemaking on access charge reform, in which it reaffirmed the observation that the loop is a common cost.

- Final Decision and Order, In Re US West Communications, Inc., Iowa Utilities Board, Docket No. RPU-95-10, May 17, 1996, p. 295 and 306;
- Final Decision and Order, In Re US West Communications, Inc., Iowa Utilities Board, Docket No. RPU-94-1, November 21, 1994;
- In re Application of GTE Southwest, Inc., and Contel of the West, Inc., to Restructure Their Respective Rates, New Mexico State Corporation Commission, Docket NO. 94-291-TC, Phase II, December 27, 1995, pp. 11, 14-15;
- New England Telephone Generic Rate Structure Investigation, New Hampshire Public Utilities Commission, March 11, 1991, DR 89010, pp. 39-40;
- Order No. 18598, In re Investigation into Nontraffic-Sensitive Cost Recovery, Florida Public Service Commission, 1987; Docket No. 860984-TP, pp. 258, 265-266;
- Order No. U-15955, Ex Parte South Central Bell Telephone Company, Docket No. 1-00940035, Louisiana Public Service Commission, September 5, 1995, p. 12;
- In the Matter of a Summary Investigation into IntraLATA Toll Access Compensation for Local Exchange Carriers Providing Telephone Services Within the State of Minnesota, Minnesota Public Utilities Commission, Docket No. P-999/CI-85-582, November 2, 1987, p. 33.

10 FCC, Implementation of the Local Competition Provisions of the Telecommunications Act of 1996, First Report and Order, CC Docket No. 96-98, para. 678.

> For example, interstate access is typically provided using the same loops and line cards that are used to provide local service. The costs of these elements are, therefore, common to the provision of both local and long distance service.[11]

The FCC applied this conclusion in its decision to convert the Common Carrier Line (CCL) charge into a flat rate charge to cover loop costs.

> We reject claims that a flat-rated, per line recovery mechanism assessed on IXCs would be inconsistent with section 254 (b) which requires "equitable and nondiscriminatory contribution to universal service by all telecommunications providers." The PICC is not a universal service mechanism, but rather a flat-rated charge that recovers local loop costs in a cost causative manner.[12]

In the reform of the separations process, the FCC has stated the economic reasoning and analysis which underpins this treatment of the loop.

> Nearly all ILEC facilities and operations are used for multiple services. Some portion of costs nonetheless can be attributed to individual services in a manner reflecting cost causation. This is possible when one service, using capacity that would otherwise be used by another service, requires the construction of greater capacity, making capacity cost *incremental* to the service. The service therefore bears a causal responsibility for part of the cost. The cost of some components in local switches, for example, is incremental (i.e. sensitive) to the levels of local and toll traffic engaging the switch. Most ILEC costs, however, cannot be attributed to individual services in this manner because in the case of joint and common costs, cost causation alone does not yield a unique allocation of such costs across those services. The primary reason is that shared facilities and operations are usually capable of providing at least one additional service at no additional cost. In such instances, the cost is *common* to the services. For example, the cost of a residential loop used to provide traditional telephony services, usually is common to local, intrastate toll, and interstate toll services. In a typical residence, none of these services individually bears causal responsibility for loop costs because no service

---

11 FCC, In the Matter of Access Charge Reform, Price Cap Performance Review for Local Exchange Carriers, Transport Rate Structure and Pricing, End User Common Line Charges, Notice of Proposed Rulemaking, CC Docket Nos. 96-262, 94-1, 91-213, 95-72, para. 237.

12 FCC, In the Matter of Access Charge Reform, Price Cap Performance Review for Local Exchange Carriers, Transport Rate Structure and Pricing, End User Common Line Charges, First Report and Order, CC Docket Nos. 96-262, 94-1, 91-213, 95-72, para. 104.

> places sufficient demands on capacity to warrant installation of a second loop. Another reason why a relationship may not exist between cost and individual services is that some shared facilities or operations provide services in fixed proportion to each other, making the cost *joint* with respect to the services. ILEC billing costs, for example, tend to be joint with respect to local, state toll, and interstate toll services. For the majority of bills rendered, billed charges always include all three services. The fixed combination of services makes it impossible for one service to bear responsibility for billing costs . . . .
>
> Both incremental cost and stand-alone cost (which are usually expressed per unit of output) are greatly affected by the way we choose to define the increment and the service class. The incremental cost of carrying an additional call from residences to end offices, for example, is zero if the residences are already connected to end offices, but the incremental cost of establishing such connections is the cost of the loops. [13]

The importance of getting loop allocation correct cannot be overemphasized. As the FCC notes, the proper identification of loop costs is critical to telecommunications pricing, since loop constitutes almost half of all costs of local exchange carriers.[14] For example, ARMIS data indicates that loop plant investment in 1996 was 49% of total plant investment.

B. FCC IMPLEMENTATION OF UNIVERSAL SERVICE STATUTORY PROVISIONS

Most importantly, the FCC's methodology for estimating costs of basic service for purposes of identifying high cost areas is consistent with the FCC's policy in implementing the 1996 Telecom Act. The proposals put forward by the industry, however, improperly tend to include the costs but not the revenues. These are inconsistent with the fundamental principles adopted by the FCC that costs and revenues

---

13 FCC, In the Matter of Jurisdictional Separations Reform and Referral to the Federal-State Joint Board, Notice of Proposed Rulemaking, CC Docket No. 80-286, November 10, 1997, (hereafter Separations NPRM) pp. 14 and 15.

14 Separations NPRM, p. 16.

must be matched. The FCC has constructed a paradigm that starts from the fundamentally correct premise that the loop is a shared cost. It follows that up with a cost principle that requires costs to be recorded for all facilities used by all services. It concludes in the universal service proceeding by recognizing that all costs included for the estimation of a set of services that share common facilities must be matched by the revenues generated by those common facilities.

For example two of the ten criteria it establishes for specification of a cost model require similar treatment of joint and common costs:

> (2) Any network functionality or element, such as loop, switching, transport, or signaling, necessary to produce supported services must have an associated cost.
>
> (7) A reasonable allocation of joint and common costs must be assigned to the cost of supported services. This allocation will ensure that the forward-looking economic cost does not include an unreasonable share of joint and common costs for non-supported services.[15]

Administratively, the FCC has declared its intention to compare the cost of basic service on a national average basis to the revenues earned per line. The reference price includes revenues from a number of sources.

> As the Joint Board recommended, the revenue benchmark should take account not only of the retail price currently charged for local service, but also of other revenues the carrier receives as a result of providing service, including vertical service revenue and interstate and intrastate access revenues. Failure to include all revenues received by the carrier could result in substantial overpayment to the carrier.[16]

The FCC ties the inclusion of revenues directly to the sharing of costs.

> We include revenues from discretionary services in the benchmark for additional reasons. The cost of those services are included in the cost of

---

15 FCC, Universal Service Order, para. 250.

16 FCC, Universal Service Order, para. 200.

> service estimates calculated by the forward-looking economic cost models that we will be evaluating further in the FNPRM. Revenues from services in addition to the supported services should, and do, contribute to the joint and common costs they share with supported services. Moreover, the former services also use the same facilities as the supported services, and it is often impractical, if not impossible, to allocate the costs of facilities between the supported services and other services. For example, the same switch is used to provide both supported services and discretionary services.[17]

V. CONSISTENCY IN ESTIMATING THE NEED FOR SUPPORT

If the FCC starts with this sound economic, legal, and public policy basis for implementing its universal service policy, it should be possible to develop a reasonably sized fund that accomplishes the goals of the Act without creating substantial pressures to increase basic rates. Implementation must be consistent with the principles cited above and the FCC's authority.

Several of the large, non-rural LECs would not only have the FCC abandon the sound legal and economic basis on which it has launched its 1996 Act universal service policy, but they would also have the FCC misapply its methodology. In particular, they urge that the FCC to allow universal service support to be calculated on the basis of a radically different view of the network than the one used for calculation of unbundled network elements. OPC believes that the FCC should apply a consistent view of the network that reflects its economic nature.

A. MATCHING COSTS AND SUPPORT

Upon the completion of the transition, the forward-looking economic costs and the sum of the unbundled network elements should be equal. The whole should equal the

---

17 FCC, Universal Service Order, para. 261.